BILL DRAFT 2007-RBz-39B: Reports by Publicly Traded Partnerships

BILL ANALYSIS

Committee:	Revenue Laws Study Committee	**Date:**	May 7, 2008
Introduced by:		**Summary by:**	Cindy Avrette
Version:	Bill Draft		Committee Staff

SUMMARY: ***This bill draft would require publicly traded partnerships (PTPs) to file an informational return with the Secretary of Revenue that lists the partners who received more than $500 of income from the partnership during the taxable year. This return would be in lieu of the current requirement for partnerships to report the distributive share of the income of each member and to pay the tax on any nonresident member's share of income. The bill would become effective for taxable years beginning on or after January 1, 2008.***

CURRENT LAW: A partnership doing business in this State must file an information return with the Department of Revenue that gives the name and address of each person who would be entitled to share in the partnership's net income, if distributable, and the amount each person's distributive share would be. A partnership that files a report must also furnish to each partner the information needed by that partner to file a North Carolina income tax return. For nonresident members of a partnership, the partnership must pay income tax for that partner based on the partner's distributive share.

BILL ANALYSIS: Legislative Proposal X, *Reports by Publicly Traded Partnerships,* changes the reporting and payment requirements that apply to PTPs that qualify as a PTP under section 7704(c) of the Internal Revenue Code. It requires a PTP to report annually to the Department of Revenue the partners in the PTP who received more than $500 of income rather than report the income received by every partner. It also exempts PTPs from the requirement to pay tax on the partnership income received by a nonresident. In making these changes, the proposal seeks to strike a balance between the costs and burden of compliance with the reporting requirements for both the PTPs and the Department of Revenue and the benefits gained by compliance.

A PTP is a limited partnership the interests in which are traded on stock exchanges such as the New York, American, and NASDAQ exchanges. Unlike a traditional partnership, a PTP has tens of thousands, and sometimes hundreds of thousands, of unitholders.[1] A PTP's unitholders can change daily in trades on public exchanges. A PTP determines who its unitholders are once a year so the PTP can send K-1s to the unitholders.

PTPs operate in several states. The amount paid by any unitholder once a PTP's taxable income has been divided up among all unitholders and apportioned among all the states in which the PTP does business will rarely be a large amount, and in many cases will be under the state threshold for paying tax. In looking at the PTPs in North Carolina, only a small number of their unitholders has income above $500 from the partnership during the taxable year.[2] The information reportable to the Department under this proposal would allow it to cross-check a handful of entities and individuals to ensure they are paying tax owed to North Carolina.

[1] Many of the units are held in 'street names' by brokerage houses.

[2] A survey of seven PTPs in N.C., conducted by the National Association of Publicly Traded Partnerships, showed that the PTPs had more than 200,000 unitholders. Of those 200,000 unitholders, only seven of them had income levels of more than $500 and only four of them had income levels above $1,000. Of the unitholders with income above $500, six of them were corporations.

PTPs pay their unitholders quarterly cash distributions. [3] Although the distributions resemble corporate dividends, PTP distributions are treated differently for tax purposes. The distributions are treated as a return of capital rather than taxable investment income and reduce the partner's basis in its partnership units.[4] When the units are sold, the difference between the sales price and the adjusted basis equals taxable gain or loss. The partner is not taxed on the distributions until (1) it sells the PTP units and pays tax on the gain or (2) its basis reaches zero.[5]

Every unit in a class of securities must be identical to, and interchangeable with, every other unit so that it makes no difference to a purchaser which particular units are bought. If a PTP pays state tax for a nonresident unitholder and deducts the payment from the unitholder's share, the nonresident's units will have different attributes than those held by state residents, and that would cause the PTP to be in noncompliance with federal security laws and to forfeit its exchange listings.

The Multi-State Tax Commission has adopted a model statute that exempts PTPs from reporting and payment requirements for nonresident members of pass-through entities. Twenty-six states have excluded PTPs from tax payment requirements for nonresident partners through either specific legislation or administrative action. Eight states exempt PTPs from reporting distributions to its partners except for distributions of income that exceed $1,000 during the taxable year.

BACKGROUND: PTPs initially came into existence during the 1980s as a means for companies to raise large amounts of capital that are used to build or buy capital-intensive assets, like pipelines. The limited partnership has one or more general partners that mange the partnership and limited partners that provide capital to the partnership.

Under the Internal Revenue Code, a PTP may be treated like a partnership for income tax purposes rather than a corporation if it meets the 'qualified income test' under section 7704(c) of the Code: a PTP must generate 90% of its income from qualified sources. Qualified sources include real estate activities, mineral or natural resources activities like exploration, production, mining, refining, marketing, and transportation of oil, gas, minerals, geothermal energy, and timber. Most PTPs that meet the section 7704(c) income restrictions are in energy or real estate related businesses. There are approximately 90 PTPs that meet this requirement in the country, and 10 in North Carolina.[6]

Since the Code treats a section 7704(c) PTP like a partnership, the PTP itself does not pay tax. Rather, its income and other tax items are 'passed through' to the individual partners. A PTP investor receives a K-1 form at the end of each year showing its share of each item of partnership income, gain, loss, deductions, and credits. The investor uses that information to determine its taxable partnership income.[7]

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[3] The cash distributions are unrelated to the partner's share of taxable income, which is received only on paper. Partners are liable for tax on their share of partnership income whether or not they receive a cash distribution.

[4] The investor's original basis is the price paid for the units. The basis is reduced by each distribution that is treated as a return of capital and is increased or decreased, as appropriate, with each allocation of the PTP's net income or loss.

[5] It usually takes years for a partner's basis to be reduced to zero because the basis is constantly adjusting up and down, as described in the preceding footnote.

[6] The ten PTPs in N.C. are involved in pipelines (1), terminal facilities (2), propane gas (5), and real estate (2). N.C. PTPs include Magellan Midstream Partners, Spectra Energy Partners, AmeriGas, and Ferrell Gas.

[7] If the result is net income, the partner pays tax on it at its individual rate. If the result is a net loss, it is considered a 'passive loss' and may not be used to offset income from other sources; it must be carried forward and used to offset future income from the same PTP.